

Issue no. 5: When Lease Return Costs Should Be Accounted For - Engine Swaps

Background

Lease agreements often contain provisions that require lessees to either return the airframe and engine in a certain maintenance condition or pay an amount to the lessor based on the airframe and engine's actual return condition. Typically, an aircraft is expected to be returned at "half-time," which presumes that at least 50 percent of the eligible flight time since the last overhaul is remaining when the aircraft is returned to the lessor. Generally, there are three ways an airline can satisfy its obligations under such leases: (1) performing maintenance (either internally or by contracting a third-party service provider) to return the aircraft to the level of maintenance required by the contract, (2) paying cash to compensate the lessor if the aircraft is returned with less flight time remaining than specified under the lease, and (3) swapping owned components (or other leased components) for leased components (engines).

AcSEC has previously agreed that lease return costs should be accounted for in a manner similar to the accounting for contingent rent, that is, recognized over the remaining life of the lease in accordance with EITF 98-9, *Accounting for Contingent Rent*, beginning when it is probable the costs will be incurred. The objective is to recognize the expense for lease return costs as the related aircraft hours accumulate, beginning when it is probable that such costs will be incurred and they can be estimated.

AcSEC has also concluded that incurrence of lease return costs becomes probable and the amount of those costs can be estimated only near the end of the lease term (i.e., as the aircraft approaches its last maintenance cycle).

AcSEC also has considered accounting for swaps but decided to defer further discussion until the issuance of FASB guidance on Exchanges of Nonmonetary Assets.

Authoritative Accounting Literature

FASB Statement No. 153, *Exchanges of Nonmonetary Assets*

APB Opinion No. 29, *Accounting for Nonmonetary Transactions*

EITF 98-9, *Accounting for Contingent Rent*

Discussion of the Issue

In satisfying lease return conditions, many airlines will swap owned or leased engines (similar model, vintage [the date the engine was manufactured], remaining useful life and economic cash flows) with sufficient remaining flight time to satisfy lease return conditions at the lease termination date. These swaps usually occur at either the last maintenance event prior to return or at a date near the lease termination date. Historically, the airlines have accounted for these engine swaps as nonmonetary exchanges of similar productive assets under APB Opinion No. 29, *Accounting for Nonmonetary Transactions*. Aircraft engines are swapped multiple times over the life of the lease. Every time an engine is overhauled, it is removed from the aircraft and a

different engine is installed in order to keep the aircraft in service while the removed engine is being overhauled.

The task force has evaluated engine swap accounting using the provisions of Statement of Financial Accounting Standards No. 153, *Exchanges of Nonmonetary Assets* (Statement 153). The task force has concluded that engine swaps during maintenance cycles prior to the last repair cycle lack commercial substance as the timing and amount of cash flows is not substantially different and the difference in entity specific value is not significant. The task force has also concluded that an engine swap during the airline's final maintenance cycle also lacks commercial substance.

These engine swaps should be evaluated under paragraph 21 of Statement 153, which provides:

“A nonmonetary exchange has commercial substance if the entity's future cash flows are expected to significantly change as a result of the exchange. The entity's future cash flows are expected to significantly change if either of the following criteria is met:

- a. The configuration (risk, timing, and amount) of the future cash flows of the asset(s) received differs significantly from the configuration of the future cash flows of the asset(s) transferred.

- b. The entity-specific value of the asset(s) received differs from the entity specific value of the asset(s) transferred, and the difference is significant in relation to the fair values of the assets exchanged.”

The task force in reaching their conclusions considered two common fact patterns:

Scenario One:

The lease contains a provision that requires the engines to have 50 percent remaining flight time at the lease return date. At the beginning of the last maintenance cycle the airline determines it is probable that a lease return liability will be incurred for the two on-wing engines and begins to accrue lease return costs over the remaining term of the lease. It is assumed the engines will have little to no remaining flight time at the lease return date. Approximately, mid-way through the last maintenance cycle the airline swaps the on-wing engines for engines expected to have sufficient remaining flight time at the lease return date to satisfy the lease return provisions.

Scenario Two:

Same facts as scenario one but the engine swap occurs at the end of the lease term.

In each scenario the task force believes that the amount of cash flows (whether it's the maintenance cash flows or cash flows from operations) is the most relevant factor in assessing whether criteria (a) in paragraph 21 has been met. If evaluating the timing and amount of the maintenance cash flows, the cash flows for maintenance related to the on-

wing engines will not change significantly irrespective of when the engine swap occurs. Additionally, the timing and amount of the maintenance cash flows related to the replacement engines also will not change significantly. If the on-wing engines are not swapped then the airline will pay the lease return liability, avoid the maintenance costs for the on-wing engines, continue to maintain the replacement engines and will have the economic use of the replacement engines' remaining flight time. If the on-wing engines are swapped the airline will incur maintenance costs for the on-wing engines, avoid paying the lease return liability, avoid the future maintenance costs on the replacement engines and lose the economic use of the replacement engines' remaining flight time. The only difference in cash flows occurs when the airline decides to pay the lease return liability. In this case, there is a present value difference related to the timing of the lease return payment as compared to the incurrence of the maintenance costs related to the on-wing engines (generally the difference is less than 18 months).

Another way of analyzing the cash flows related to these engines is by viewing them as being derived from operation of the engine in the airline's revenue generating activities. Although the timing and amount of cash flows related to the specific maintenance activities may differ (as the replacement engine will generally have 50 percent remaining until the scheduled maintenance and the on-wing engine will have less remaining flight time and will need to be overhauled sooner), the economic cash flows generated by the engines would likely be substantially identical as the engines are generally the same make, model, vintage and would have substantially identical use to the airline.

With respect to criteria (b) in paragraph 21, the task force believes the above factors also support the view that there is not a significant difference in entity specific value.

Lastly, if the engines are swapped the task force discussed when the lease return liability should be reversed. The task force concluded that the liability should be reversed when the aircraft is returned to and accepted by the lessor, which is the point when the liability is legally extinguished.